IT 01-12
Tax Type: Income Tax
Issue: Audit Methodologies and/or Other Computational Issues

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	**No. 99-IT-0000** **FEIN 00-0000000**
v.	**Tax yrs. 6/30/93, 6/30/94**
ABC Corp. & subs., **Taxpayer**	**Charles E. McClellan** **Administrative Law Judge**

RECOMMENDATION FOR DECISION

Sean P. Cullinan, Special Assistant Attorney General, for the Department of Revenue.
Charles J. Greene, Esq. of Melbourne, Florida, admitted *pro hac vice*, for the taxpayer.

Synopsis:

This matter arose from a protest filed to a Notice of Deficiency issued by the Department to ABC Corp. and its subsidiaries ("ABC") on June 2, 1999 for the taxable years ended June 30, 1993 and June 30, 1994. The only issue for consideration is whether ABC, which uses the percentage-of-completion method of accounting for its fixed price contracts, is entitled to include its unbilled costs account in the property factor of its apportionment formula for calculating its Illinois income tax liability. ABC waived its right to an evidentiary hearing and asked that the matter be decided on the basis of a stipulation of facts and the briefs filed by the parties. I recommend that the Notice of

Deficiency be recalculated with ABC's unbilled costs account included in the property factor of the apportionment formula.

Findings of Fact:

1. The Department of Revenue issued to ABC a Notice of Deficiency on June 2, 1999 for Illinois income and replacement tax owed for the taxable years ended June 30, 1993 and June 30, 1994 ("the tax years"). Stip. ¶ 1, Ex. No. 1.
2. ABC concedes all issues raised in the Notice of Deficiency except for the exclusion of unbilled costs in the property factor of its apportionment formula. Stip. ¶ 10
3. ABC is engaged in the business of manufacturing and selling semiconductors, commercial communications equipment, and the engineering, design, and construction of complex communications systems and devices for the U.S. Department of Defense, NASA, and other government agencies. Stip. ¶ 2.
4. These business activities were conducted in three individual sectors, those being the semiconductor sector, the communications sector, and the electronic system sector. *Id*.
5. The electronic systems sector generally conducted business through long-term contracts entered into with customers. Long term contracts are contracts that extend over one year from start to finish. *Id*.
6. Some of these long-term contracts were "fixed price" contracts for which the taxpayer adopted the percentage-of-completion method of accounting. *Id*.

7. The “unbilled costs on fixed price contracts” account (“the unbilled costs account”) is an account used in the percentage-of-completion method of accounting to record incurred costs and anticipated profits with respect to fixed price contracts before they are invoiced to the customer. Stip. ¶ 5.

8. The unbilled costs on fixed price contracts include all costs which have been incurred in working toward completion of each specific contract but not yet invoiced to the customer during the development and production of the property that will be delivered to the customer to complete performance of a contract. *Id*.

9. The costs are direct costs, such as labor and material, and indirect costs such as overhead and general and administrative expenses. *Id*.

10. The account also includes the profit anticipated with respect to those costs. *Id*.

11. The profit associated with the unbilled costs that are included in the account is reported as net profit for the accounting year in which it is earned and is included in the income to which the apportionment factors will be applied. *Id*.

12. The following steps are included in accounting for a fixed price contract project under the percentage-of-completion method of accounting:

    A. ABC enters into a contract with a customer for the supply of unique property at a fixed price. Payment is based on completion of milestones with partial payments being made during the course of performance as the milestones are reached.

    B. ABC begins to incur costs in performing its obligations under the terms of the contract. The costs include direct labor, materials cost and overhead.

In accounting for these costs, ABC will debit the cost of sales account for the cost incurred and credit accounts payable or a cash account for an equal amount.

C. On a monthly basis, ABC will record revenue and costs recognized on the basis of the percent of completion reached. For example, if the project is 10% completed, the accounting entries will be a credit to sales for 10% of the contract price and a debit to the unbilled costs account for 10% of the expected costs to be incurred plus 10% of the anticipated profit on the contract.

D. When a billing milestone is reached, an invoice is sent to the customer for the milestone percentage-of-completion called for in the contract, i.e., 20%, 30%, etc. The accounting entries are a debit to accounts receivable and a credit to the unbilled costs account for the amount billed.

E. The steps set forth above, A, B, C and D, continue until the contract is completed and the final invoice is sent to the customer at which point the unbilled costs account will be zero for that contract. Stip. ¶ 6.

Conclusions of Law:

ABC is the parent of a unitary group of corporations that filed its Illinois income tax returns for the tax years at issue on a combined basis apportioning its business income using the three factor formula method prescribed in Section 304(a) of the Illinois Income

Tax Act[1]. This method involves calculating three fractions: (1) Illinois property over all property of the business; (2) Illinois payroll over all payroll; and (3) Illinois sales over all sales. The three fractions are then averaged, with the sales fraction receiving a double weight. The resulting fraction is multiplied by the business' total income in order to determine the amount of business income taxable in Illinois. Automatic Data Processing v. Department of Revenue, 313 Ill. App. 3d 433, 438-439; 729 N.E.2d 897, 903 (1st Dist. 2000).

The issue in this case involves the property factor and ABC's unbilled costs account. ABC, which uses the percentage-of-completion ("POC") method of accounting for its long-term fixed price contracts, included its unbilled costs account (an account required under this method of accounting) in the property factor of its apportionment formula. The Department excluded the unbilled costs account from the property factor.

The financial accounting and federal income tax rules for the POC method of accounting for long-term contracts are generally the same. These rules require income and costs incurred in performing a long-term contract to be taken into account ratably over the contract period. Using this method, a taxpayer includes in income, for each tax year during which costs are incurred in performing the terms of the contract, a percentage of the total contract price based on the completion factor. 26 CFR 1.460-4(b), AICPA § 10,330.71[2]. The completion factor is determined by calculating a percentage, the

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[1] Unless otherwise noted, all statutory references are to 35 ILCS 5/101, *et seq*., the Illinois Income Tax Act ("IITA" or "the Act").

[2] ¶ 10,330 - AICPA (formerly known as the American Institute of Certified Public Accountants) Statement of Position 81-1 - Accounting for Performance of Construction-Type and Certain Production-Type

numerator of which is the actual costs incurred on the contract during the year and the denominator of which is the total estimated cost for the entire contract. *Id*. As the contract performance proceeds, the costs of manufacturing, i.e., converting the labor and material into the finished product specified in the contract, are accumulated in the unbilled costs account where they remain until the product is shipped and invoiced to the customer as provided in the contract. *Id*.

Exhibits 4 and 5 to the stipulation set forth an illustration of the accounting entries required to report income and costs incurred in performing a contract under the POC method of accounting. The example illustrates the accounting and the effect on the income statement and the balance sheet of ABC or any other taxpayer using the POC method of accounting, so it bears consideration here. The facts stated in the example are that ABC enters into a contract with a customer to build two units at $100 for a total contract price of $200 with estimated costs to complete of $180 resulting in expected profit of $20. During the tax year ABC incurs $126 in costs for material and labor to manufacture the items specified in the contract. The accounting entries to record the costs would be as follows:

Account	Debit	Credit
Cash or accounts payable		126
Cost of Sales	126	

Contracts, July 15, 1981Accounting Standards Division, Auditing Standards Division; hereinafter cited as "AICPA § n".

At the end of the tax year, ABC determines that the completion factor with respect to this contract is 70% by dividing the costs incurred ($126) by the estimated total costs to be incurred in completing the contract ($180). Even though ABC has not shipped anything to its customer or invoiced it for anything, the POC method requires ABC to reflect on its books at the end of the tax year the portion of the contract price earned as determined by the completion factor. The accounting entries to reflect this progress at the end of the tax year are as follows:

Account	Debit	Credit
Sales (70% of the contract price)		140
Unbilled costs (the costs charged to the cost of sales account during the year)	126	
Unbilled costs (70% of $20, the total profit)	14	

At the end of the year when the books are closed, ABC's income statement will report sales of $140 less cost of sales of $126 for a net profit or taxable income of $14. ABC's balance sheet will show a balance in the unbilled costs account of $140 consisting of the unbilled costs of $126 and the unbilled profit of $14.

If ABC ships one completed unit to its customer two months after the tax year end and the contract entitles ABC to invoice the customer for 50% of the contract price, the accounting entries to reflect that transaction would be as follows:

Account	Debit	Credit
Cash or accounts receivable (50% of the contract price)	100	

Unbilled costs		100

During the second year, ABC incurs the remaining cost to complete the contract. The accounting entries to reflect these transactions are as follows:

Account	Debit	Credit
Cash or accounts payable		54
Cost of Sales	54	

If the contract has been completed by the end of the second year, but the customer has not been invoiced because the final shipment has not been made, the POC method requires ABC to reflect on its books for the second year the portion of the contract price earned during that year. The accounting entries to reflect his progress are as follows:

Account	Debit	Credit
Sales (30% of the contract price)		60
Unbilled costs (the costs charged to the cost of sales account during the 2nd year)	54	
Unbilled costs (30% of $20, the total profit)	6	

At the end of the year when the books are closed with respect to this contract ABC's income statement will report sales of $60 less cost of sales of $54 for a net profit or taxable income of $6. ABC's balance sheet will show a balance in the unbilled costs account of $60 consisting of the unbilled costs of $54 and the unbilled profit of $6.

If at the end of the first month following the close of the second tax year, the taxpayer invoices its customers for the $100 balance due on the contract, the accounting entries to reflect that would be as follows:

Account	Debit	Credit
Cash or accounts receivable (50% of the contract price)	100	
Unbilled costs		100

Once the contract is complete, the unbilled costs account with respect to this contract will be zeroed out, the income and costs of the contract will have been reported for the appropriate years in accordance with the completion factor, *i.e.*, the percentage-of-completion. This example demonstrates that under the POC method of accounting the balance in the unbilled costs account at the end of any tax or reporting year represents the value of product produced but not shipped under the terms of a long-term fixed price contract.

ABC argues that the unbilled costs account represents an inventory account for tangible personal property properly includible in the factor within the language of IITA § 304(a). ABC relies on the regulations published by the Multi-State Tax Commission ("MTC") in the absence of a specific rule in the Department's regulations. ABC points out that IITA § 304(a) is almost identical to a provision in the Uniform Division of Income for Tax Purposes Act ("UDITPA") published by the MTC. ABC notes that the Department's regulation on the property tax factor, 86 Ill. Admin. Code § 100.3350, is almost identical to a similar regulation in the MTC regulations for UDITPA. That MTC regulation, MTC Reg. § IV.18 (d)(f)(iv), clearly states that the unbilled costs account is to be considered property for apportionment purposes. ABC recognizes that Illinois has not adopted the MTC regulations, and it acknowledges that the MTC regulation is not binding on Illinois. It argues, however, that because of the absence of a rule in Illinois to the contrary it is appropriate to consider the MTC regulation.

ABC also relies on AICPA § 10,330.71, and the Security and Exchange Commission regulations, 17 CFR 210.5-02(6). Both of these pronouncements treat unbilled costs accounts under the POC method of accounting as inventory accounts on the asset side of the balance sheet. Finally, ABC argues that the Department's position is based on a misunderstanding of the POC method of accounting.

The Department has several arguments in its brief. The first argument is that, "Because the costs are currently deducted and accounted for in arriving at taxable income it cannot then be deemed inventory held by the taxpayer at the end of the year. This is based on the fact that there is effectively no accumulation of costs to attribute to inventory, much less as inventory." Dept. brief p. 3. This argument fails because the parties have stipulated that the unbilled costs account is an accumulation of costs that have been converted to tangible personal property that has not yet been shipped and billed to the customer. Specifically, the stipulation states as follows:

> The "Unbilled costs on Fixed Price Contracts" account is **an account used to collect incurred costs and anticipated profits in respect of fixed price contracts** that are accounted for using the percentage of completion method. The account includes all costs, which have been incurred but not yet invoiced to the customer during the development and production of the property that will be delivered to the customer to complete performance of the

contract. . . ..
Stip. ¶ 5.

Therefore, the Department's statement that there is no accumulation of costs is in direct contradiction to facts to which it has stipulated.

The Department cites Treas. Reg. § 1.451-3(c)(1) and (3) and Prop. Treas. Reg. § 1.460-4(b) for the proposition that all costs incurred with respect to a long-term contract incurred during a taxable year must be currently deducted. :However, Treas. Reg. § 1.451-3, 26 CFR ¶ 1.451-3 was removed from the Code of Federal Regulations on January 11, 2001. 66 Fed. Reg. 2219, 2224. The current federal income tax regulation that deals with the POC method of accounting requires a taxpayer using this method to include in income each year that portion of a long term contract that corresponds to the percentage of the entire contract that has been completed that year. Costs incurred during the year in completing that portion of the contract are deducted currently. 26 CFR § 1.460(b).

Relying on the federal income tax regulations, the Department argues that unbilled costs do not represent inventory and are not analogous to work-in-progress. It draws the incorrect conclusion that because the costs have been deducted, they do not represent inventory.

The Department's reliance on these regulations is misplaced. The current regulation reflects the general accounting principle that requires costs to be matched with revenue. It has nothing to do with the presentation of unbilled costs on the balance sheet. Further, the unbilled costs account is in fact an accumulation of material, labor, and other costs incurred in the performance of a fixed price contract, *i.e.*, a manufacturing or a construction contract the performance of which requires the conversion of the raw material into the finished product over a span of time exceeding one year. Until the property is invoiced and shipped to the customer, it remains tangible personal property of ABC, properly classified as an inventory account on its balance sheet.

Next, the Department argues that the Department does have a regulation that deals with what property is includible in the property factor, and therefore, the MTC regulations are only suggestions that Illinois does not have to follow. In support of its argument the Department cites 86 Admin Code ch. I, § 100.3550(b) which states, "Property or equipment under construction during the tax period (except for inventoriable goods in process), shall be excluded from the [property] factor until such property is actually used in the regular course of the trade or business of the person."

This argument fails for two reasons. First, the Department regulation cited deals with fixed assets such as manufacturing plants or industrial buildings being constructed by a taxpayer for its own use. It does not deal with unbilled costs accumulated in performing fixed price contracts to produce items that a taxpayer has contracted to produce and sell to its customers. Second, the regulation specifically excludes from its application inventoriable goods, *i.e.*, work-in-process, which is akin to the unbilled costs account required by the POC method of accounting.

Although the Department argues that the unbilled costs account is not akin to work-in-progress, this argument is not supported by any federal or state income tax regulation. Moreover, as noted below, it runs counter to the Securities and Exchange Commission regulations and the AICPA standards of accounting for long term contracts including contracts for construction of airplanes, weapons systems, buildings, roads, bridges and similar construction-type projects.

The IITA statutory provision that addresses the question of what property belongs in the property factor is § 304(a). It provides that the property to be included in the factor is the "real and tangible personal property owned or rented and used in the trade or business" during the year. The applicable regulation provides as follows:

> The property factor of the apportionment formula for each trade or business of a person shall include all real and tangible personal property owned or rented by such person and used during the tax period in the regular course of such trade or business. The term "real and tangible personal property" includes land, building, machinery, stocks of goods, equipment, and other real and tangible personal property but does not include coin or currency. 86 Ill. Admin. Code § 100.3350(a).

For federal income tax purposes, taxpayers that use the POC method of accounting must allocate to the contract all direct costs such as labor and materials and such overhead as is directly related to the contract. 26 CFR 1.460-5. The AICPA standards of accounting also include in contract costs all direct costs, such as materials and direct labor, subcontracts, and indirect costs identifiable with or allocable to the contract. AICPA §§ 10,330.09, 10,330.72. "Contract costs are accumulated in the same manner as inventory costs and are charged to operations as the related revenue from contracts is recognized." *Id*. The Securities and Exchange Commission regulations specifically require that unbilled costs be carried in the inventory section of the taxpayer's balance sheet. 17 CFR 210.5-02(6)(d).

These costs did not just disappear as the Department asserts. They represent material, labor and other costs in manufacturing the property that the customer specified in the contract. Economically, these costs were converted into the tangible personal property to be shipped to the customer according to the terms of the contract. When the property is shipped to the customer and the customer is billed for the partial payment specified in the contract, the unbilled costs related to that contract will be eliminated from the unbilled costs account. Until that happens, the property represented by the unbilled costs account remains the property of the taxpayer.

The record in this case establishes that ABC's use of the POC method of accounting conforms to federal income tax and generally accepted accounting rules for accounting for unbilled costs. It also establishes the fact that the account represents tangible personal property owned by ABC and that it is in its possession at the end of each taxable year properly reported in the inventory section of ABC's balance sheet. Therefore, ABC's unbilled costs come within the definition of property to be included in the property factor of the apportionment formula as set forth in IITA § 304(a) and the relevant regulation, 86 Ill. Admin. Code § 100.3350(a).

For the reasons stated above, I recommend that the Notice of Deficiency be recalculated with ABC's unbilled costs account included in the property factor of the apportionment formula. As so adjusted, I recommend that the Notice of Deficiency be made final.

ENTER: July 31, 2001

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Administrative Law Judge